DR. KURT RICHEBÄCHER

English Correspondents:
Hahn Capital Partners Inc.
CANADA

Frankfurt
GERMANY

CURRENCIES AND CREDIT MARKETS

No. 214 / February 1991

"The deficit country is absorbing more, taking consumption and investment together, than its own production; in this sense its economy is drawing upon savings made for it abroad. Whether this is a good bargain or not depends upon the nature of the use to which these funds are put. If they merely permit an excess of consumption over production, the economy is on the road to ruin."

Joan Robinson
Collected Economic Papers, pg. 23.

HIGHLIGHTS

One thing is now clear beyond any shadow of a doubt: the world boom that started in 1982-83 has been aborted.

One can also be sure that the last Bundesbank tightening will prove to be the high-tide mark for Germany and therefore also for European interest rates. It's high time to be in long-term bonds.

The recessions presently unfolding in the Anglo-Saxon countries differ fundamentally from any earlier economic downturn of the post-war period. These "new" recessions result from a "growth crisis" and an unprecedented build-up of dead-weight debt.

The key point to see is that these countries suffered an unprecedented corrosion of their economy's growth potential in the 1980s as they boosted consumption at the expense of investment and foreign trade.

Productive debt is both self-supporting and self-liquifying, but nonproductive debt inexorably turns into a debt-trap over time. Since the latter does not add to income growth, soaring debt-service costs eat up an increasing share of current income. There is simply no way of avoiding the final collapse of a debt-propelled consumption boom.

We hesitate to call this a "credit crunch". Obvious symptoms of overindebtedness are mistaken for signs of monetary tightness. Overindebted consumers and corporations are not so much starving of credit as they are being strangled by illiquidity caused by the previous debt excesses.

This time, a convenient source of corporate reliquification is non-existent because inventories are already at all-time lows relative to sales even before the onset of recession. Debt-laden firms, consequently, must resort to other far more deleterious devices to regain financial breathing room.

Consumer incomes are therefore falling faster than outlays because businesses have been slashing employment at a rate never seen before so early in a recession.

Taking all this into consideration, we can only conclude one thing for America and the other Anglo-Saxon economies: there is no way out other than the disastrous road of massive credit expansion, inflation and permanent currency devaluation.

THE ANGLO-SAXON CONSUMPTION-DEBT TRAP

The recent G7 meeting was surely memorable. No sooner did a few days pass than did the Bundesbank raise its key interest rates despite all the foreign worries and pleas. It comes at a time when most other countries are trying to loosen the credit reins in order to fight off incipient recession. One day later, the Fed followed with the opposite move, lowering its discount and money market rates.

The important, if not obvious, message of these diametrically opposed actions is that the great days of international policy and exchange rate coordination are a thing of the past. Domestic issues and policy requirements now take first priority whatever the consequences for exchange rates.

This reordering of priorities has two cogent reasons: a wide and still-widening divergence in economic performance between Germany and the rest of the world — particularly between Germany and the United States, and, different national attitudes and sensitivities towards inflation. Sooner or later, therefore, both moves had to happen.

Whatever the case, it appears that the hard-liners in the Bundesbank wanted to get the attention of three main audiences: firstly, their own government and other West German public authorities that fail to restrain their burgeoning expenditures; secondly, trade unions demanding double-digit wage rises; and last but not least, financial markets both national and international.

A cynic might say that if the Bundesbank wanted to demonstrate its supreme independence, given the prevailing controversial conditions, it could not have chosen a better moment. To quote Karl Otto Pöhl, the Bundesbank president: *"In order to be credible, we cannot make our decisions dependent on politics."*

In view of the Bundesbank's long and excellent record as an uncompromising inflation fighter, one may well ask whether there was any need for such a demonstration. Unfortunately, the markets virtually called for it. Let's not forget that since early last year, when the financial costs of unification became an obsessional topic, many international analysts who play a leading role in forming market opinion have been busily taunting the credibility of the Bundesbank. According to them, the Bundesbank had gone soft under the pressure of Chancellor Kohl.

As it turns out, the rate hike actually lowered German market interest rates along the whole rate structure from six month maturities and out by almost one half of a percentage point.

BONDS: SOME POSITIVE DEVELOPMENTS

As the Gulf war rages on, a more pleasing message for financial markets thus far is that oil prices seem set to stay at a relatively low level. Even if the war is prolonged, all indictions so far are that Saddam Hussein does not have the capacity to disrupt the flow of oil.

Even more important, though, are two messages conveyed by worldwide economic indicators: first, world economic growth is on the slide; and second, the world economy is becoming increasingly desynchronized.

Recessions have crashed onto the scene with a vengeance in all the English-speaking countries, whereas the rest of the world continues to move ahead. Continental Europe and Japan are still experiencing positive growth, however, at a sharply decelerating pace, notably so in France, Spain, Italy and even in Japan. The one major country which continues full-speed ahead is Germany which remains driven by the massive demand stimulus prompted by unification.

One thing of crucial importance that is now clear beyond any shadow of a doubt is that the world boom that started in 1982-83 has been aborted. In two or three more months, recession, rather than inflation pressures will have become the over-riding concern for most countries. A weak world economy, lower oil prices and other commodity prices will act to reduce inflation almost everywhere. One can also be sure that this last Bundesbank tightening will prove to be the high-tide mark for Germany and therefore also for European interest rates. **It's high time to be in long-term bonds.**

THE CHOICE OF CURRENCY RANKS FIRST

In what currency should one buy bonds? That's the tantalizing question for the international investor. After years in which the high-yielding bonds of the booming debtor and deficit countries won the performance derby, the trend began to turn last year in favour of the creditor and surplus country currencies. A monetary tightening and sharply higher interest rates in Germany and Japan has suddenly braked their high levels of capital exports.

As a result of this sea-change in global capital flows, something is happening that seems to perplex most of the world's currency experts. For the first time in many years, fundamentally weak currencies become weak and strong currencies turn strong.

From an international investor's perspective, the total return of any asset consists of three parts: current yield, the change of the asset's domestic price over the period of investment, and third, the change in the currency exchange rate. The dynamics of the currency markets, though, are such that they can easily eclipse the trends of the other two factors.

CHASING CYCLICAL CAPITAL GAINS

One of the best-known investment "rules of thumb" is that securities markets are strongly related to business cycle fluctuations and changes in monetary policy. Under the impact of a monetary easing, the bond and stock markets usually begin to take off in the midst of recession. Chasing those cyclical capital gains — which can be quite spectacular — has become a favourite game for investors.

Sliding economies have prompted monetary easing in all of the Anglo-Saxon countries. As a result, we are faced with the paradox that these countries have experienced buoyant bond and stock markets in recent months, while the robust European economies have been marked by sluggish capital market performances. In short, it's the old cyclical game of habit, without any consideration given to ravaged fundamentals and collapsing currencies.

It is conveniently ignored that all these countries are paying for their lower interest rates through a sharply falling currency. Only Britain, which is caught in the European Monetary System (EMS)

interest-rate trap, remains stuck with its high interest rates.

THE COST OF EASIER MONEY: SLIDING CURRENCIES

Since early 1990, the dollar has dropped 15%. Overall, since its mid-1989 peak of DM 2.045, the U.S. dollar has lost 29% against the D-mark. These represent enormous losses or gains. For European investors, these currency set-backs have more than cancelled out any domestic returns on their dollar assets. The European is locked into increasing losses.

The dollar-based investor, of course, is pleasurably experiencing the reverse, reaping threefold returns on DM-related bonds: attractive yields, modest capital gains due to falling interest rates and huge currency gains on the D-mark against the dollar.

Considering the performance of the Deutschemark and DM-based bonds in the past year and prospects for 1991, one fact of crucial importance is this: the DM has surged without any capital inflows from abroad. Foreign investors, frightened by the costs of unification, shunned investment in German securities. Foreign sales of DM-bonds slightly exceeded their purchases. What drove the DM up was a dramatic reversal in German capital outflows. That's the key point to see.

What happened was that German investors switched from buying foreign bonds to buying DM-bonds. Instead of weakening the D-mark, German unification had the opposite effect by stopping German capital outflows. As a result the German capital account has strengthened faster than the current account has weakened. This dynamic in the capital account is the true cause of the strong D-mark. Nothing has been more misguided than to suppose that unification would weaken the German currency.

All of that's past now. What about the future? Can this stellar performance of the D-mark be expected to continue? To answer that question we must return to our line of pursuit: the prospect for the U.S. and the dollar-satellite currencies.

THE DOLLAR PSYCHOLOGY: EVER HOPEFUL

The one thing that strikes us after reviewing numerous reports of international analysts is that almost all of them continue to play down the dollar risk. They failed to see it beforehand and they don't recognize it now.

This attitude has an obvious reason: underlying optimism about the U.S. economy. The crucial, widely-held assumption underlying the continuing complacency on the U.S. dollar is that the U.S. economy will pull out of a short and shallow recession by the middle of 1991 just as the robust Japanese and German economies begin to lose steam.

The critical foundation of this outlook is that this expected shift in the respective business cycles, in turn, would reverse relative monetary conditions. As the U.S. economy stops falling, the Fed will have to ease off the monetary accelerator pedal. Conversely, the Bundesbank and the Bank of Japan, faced with weakening economies, will stop tightening and be forced to ease sooner or later.

This line of reasoning frequently concludes with the view that, yes, the dollar may yet suffer a further modest decline over the short-term, but, as the present stark contrast between U.S. monetary ease and German monetary tightness begins to abate, it should bottom out and rebound rather quickly towards DM 1.60 to 1.80 and more by year-end.

As far as this cyclical pattern of the dollar's behaviour is concerned, we couldn't agree more. Due to the impact of capital flows, the dollar tends to be strong during U.S. business recoveries and weak during U.S. business recession. The Achilles heel of this sequential logic lies in the assumption that the current U.S recession will be mild and shallow. What happens to the dollar if the downturn is as long and severe as we assume?

A TWO-SIDED DILEMMA

In past letters, we have carefully explained why the presently unfolding U.S. recession is fundamentally different from all prior post-war recessions. The current situation can be characterized as the combination of a "growth crisis" and a "debt crisis" that are both compounding each other. While everybody is familiar with the debt problems, most people have yet to realize the nature and the extent of the damage which the credit excesses of the 1980s have done to the U.S. economy's long-term growth potential.

At the root of the damage to the U.S. economy's body is a massive shift in the use of available productive resources away from investment towards consumption. Investment has shrunk not because consumption demand is too small but rather because it has been too buoyant. For years, consumer demand artificially spurred by a runaway credit expansion has crowded out investment.

This "crowding out" process has occurred through two primary channels: by unprecedented consumer borrowing and indirectly by the tremendous proverbial wealth effects of asset price inflation. The driving force behind the two was an unbridled credit inflation. Friederich Hayek called this condition "capital consumption".

THE LONG-TERM COST OF OVERCONSUMPTION

It is very easy to determine whether a country is on the slippery road of eroding and hollowing out its foundation for future economic growth. All one needs to do is to search for any changes in the composition of GNP. Let's look at what has happened in different countries as documented in the table on the next page.

What's clearly obvious in these tables in the case of all three Anglo-Saxon countries is a surge in their consumption ratios. During the period, consumption in the United States rose four points as a percentage of GNP, in Britain more than six points and in Canada almost five points. Nothing like this has ever happened before.

From where did these three countries draw the necessary resources for such an expansion in consumption? From two sources; firstly, by running soaring current account deficits; and secondly, by ravaging their domestic capital structure, in other words, by under-investing.

ONE CASUALTY: THE BALANCE OF PAYMENTS

Over the short run it may have seemed like a free lunch. However, in the long run, there is a rising bill to be paid to foreign creditors. Every bit of the future service on the rocketing external debts means that income is diverted abroad. Correspondingly, that implies a permanent substraction from the future income and GNP growth of the debtor countries.

To illustrate the long-term impact of that point, let's use the United States as an example. The U.S. increased its foreign-held debt about $800 billion during the 1980s. Assuming an average 8% interest rate, that makes for about $64 billion in foreign debt service per year or approximately 1% of GNP . . . provided of course that debt does not increase any further.

COMPONENTS OF DEMAND
(As a Percentages of Nominal GNP)

UNITED STATES	1980	1990	CHANGE
Personal Consumption	63.0	67.0	+ 4.0
Public Consumption	20.5	20.1	- 0.4
Res. Fixed Investment	4.0	4.1	+ 0.1
Nonres. Fixed Investment	11.7	13.7	+ 2.0
Current Account	1.2	-1.7	- 2.9
BRITAIN			
Personal Consumption	59.1	65.3	+ 6.2
Public Consumption	21.2	18.5	- 2.7
Fixed Investment	17.1	19.5	+ 2.4
Current Account	1.5	-3.7	- 5.2
CANADA*			
Personal Consumption	57.1	61.7	+ 4.6
Public Consumption	22.3	22.8	+ 0.5
Plant & Equipment	8.0	6.2	- 1.8
Construction	13.6	12.1	- 1.5
Current Account	-0.1	-3.2	- 3.1
GERMANY			
Personal Consumption	56.6	54.2	- 2.4
Public Consumption	20.1	18.5	- 1.6
Plant & Equipment	8.6	9.6	+ 1.0
Construction	14.0	11.6	- 2.4
Current Account	-0.2	4.0	+ 4.2

* Figures for Canada are for the third quarter of 1990. All other 1990 figures are preliminary for year end.

The debt-service effects are not the only injury to the long-term future growth potential of the debtor countries. Even more serious are the simultaneous damages to domestic capital formation which essentially are at the expense of future productivity and income growth.

THE SECOND CASUALTY: CAPITAL FORMATION

Referring to the investment ratios found in the table on this page, the first impression one gets is that overall investment has been rather well maintained. This appearance is often praised as a highly positive sign. However, these gross investment ratios are extremely deceptive indicators. They conceal two critical developments that lurk underneath: profound deformations in the investment structure on the one hand and massive malinvestment on the other.

All three countries exhibit precisely the same two kinds of deformations in their investment structures. Firstly, relatively high interest rates have caused a drastic shift towards short-lived investments for which capital turns over quickly and where interest costs are relatively unimportant. Parenthetically,

this shift toward short-lived investment means that ever-higher gross investment is needed to counteract the resulting higher replacement requirements of the existing capital stock. Thus, the gross figures hide a falling net investment trend — in other words, a shrinking capital stock. Such a "*shrinkage in the production and investment structure*", by the way, is the central point in Hayek's depression theory.

Secondly, artificially inflated consumer demand has severely distorted the sectoral distribution of investment, much of it malinvestment. Capital was overwhelmingly attracted into activities that serve the consumer, above all, in service industries such as hotels, merchandising, office towers, restaurants . . . etc. In practice, consumer-related investment was inflated at the expense of manufacturing investment. The essence of this debt-fuelled boom, then, is not over-investment but malinvestment. Why malinvestment? Simply because the debt-fuelled consumer demand that induced these investments is unsustainable over the long-run.

For the factory sector as a whole in the United States, the rate of growth in the capital stock has averaged 0.8% per year since 1983, that being the point when the past boom started. This is less than one-fourth the rate of manufacturing capital formation that was maintained during the last 32 years. In a number of capital-intensive industries — such as metals, paper, chemicals, and petroleum — the capital stock has actually been shrinking.

In Britain, the investment picture is even worse. While the gross investment ratio is today higher than 10 years ago, net manufacturing investment has practically vanished. Taking into account the accelerated scrappings (closing of capacity) the capital stock in manufacturing may well be lower today than in 1979. By contrast, the capital stock in distribution, banking and financial services has more than doubled in the same period, rising by 111% (after depreciation).

THIRD CASUALTY: BUSINESS PROFITS

Yet, there is still another common, negative characteristic to all these overconsuming countries: that is their generally dismal profit performance. Everywhere, business profits have declined dramatically as a share of national income. Here again, we see the same picture of an overall deterioration as well as a sectoral distortion. Capital intensive and investment-related sectors fared worst whereas consumption-related businesses performed relatively better. Now, as consumption declines sharply, these latter industries are also facing a profit squeeze.

Now, contrast these developments with the structural changes that the German economy experienced. Where the Anglo-Saxons had a consumption boom and a profit squeeze, Germany experienced a boom in savings, investment, export and profits. Between 1980 and 1990, key expenditure categories in real terms rose as follows: GNP overall, 24%; public consumption, 16%; private consumption, 19%; plant and equipment expenditures, 51%; construction, 1%; merchandise exports, 70%; and imports, 50%.

It has been a consistent theme of this letter that the recessions presently unfolding in the Anglo-Saxon countries differ fundamentally from any earlier economic downturn of the post-war period. These "new" recessions result from the combination of two potent forces that depress these economies over

the long run: a deep-seated secular loss of growth potential due to chronic underinvestment and an unprecedented build-up of dead-weight debt. For an explanation of the growth crisis we refer our readers to the December 1990 letter entitled Amerisclerosis.

The key point to see is that all the Anglo-Saxon countries suffered an unprecedented corrosion of their economy's growth potential in the 1980s as they boosted consumption at the expense of investment and foreign trade. To review briefly, the three main deformations undercutting future growth: sharp rises in the relative GNP-share of consumption, large wasteful malinvestments — particularly in commercial building, and underinvestment in manufacturing — in short, deindustrialization.

THE PROFIT SQUEEZE HITS THE CONSUMER

As ominous as this resulting "growth crisis" is from a longer perspective, it does not explain the sudden and steep downturn of the deficit economies of late.

Searching for the causes of the sudden plummet of these economies, the first thing we observe is that nowhere was this recession initiated by a dramatic collapse in investment. Clearly, it is a consumer-led recession. Sharply slower consumer spending is apparently spreading throughout these economies.

But what has happened to the spend-happy consumers in these countries that they should so suddenly drop in their tracks? A confidence collapse has become the standard explanation. But why is this so markedly the case in the United States, Britain, Canada and Australia, and not in most other countries? There must be causes specific to the Anglo-Saxon countries.

As we took pains to explain in the last letter, the sharp downturn of consumer spending in these countries was obviously initiated by suddenly, sharply contracting income. In the United States, real disposable income decreased 3.6% in the fourth quarter of 1990, compared with a decrease of 0.7% in the previous third quarter. Consumer outlay, however, increased 2.7% in the third quarter and decreased 3.1% in the fourth quarter — that is, spending fell less than income. If this is a crisis, it is clearly an income crisis and not a confidence crisis considering that real spending held up much better than real income.

A CORPORATE SCRAMBLE FOR LIQUIDITY

That confronts us with the next crucial question: What is the trigger of this sharp downturn in income? The answer lies in the corporate sector which is the main originator of incomes. Consumer incomes fell because businesses have been slashing employment at a rate never seen before so early in a recession. Why is that? It leads us to the ultimate, decisive answer: business is slashing employment in response to an intensifying profit squeeze coming at a time when profit margins are already razor thin, scraping all-time lows.

In reality, there is apparently more to this employment squeeze than a profit crisis, and that is a general and desperate scramble for liquidity. In the past, businesses first pruned excessive inventories to reliquify themselves. While the production losses that ensued may have appeared dramatic, the

inventory reduction served to reliquify businesses — that always being a necessary key precondition to the following upswing.

This time, this convenient source of reliquification is non-existent because inventories are already at all-time lows relative to sales even before the onset of recession. Most economists have been lauding this state of low inventories as an auspicious sign that the current recession will therefore prove to be short and shallow. We draw the opposite conclusion.

From the short-term point of view of maintaining demand and production they may be right. But, from the longer-term perspective of business reliquification, the low inventories are an extremely negative omen. It means that the relatively easy way of rebuilding liquidity through pruning of inventories is not available this time. Debt-laden firms, consequently, must resort to other far more deleterious devices to regain financial breathing room.

We observe three reactions instead: firstly, businesses scramble to sell other assets — mostly property and operating subsidiaries. As asset sales of this kind gather momentum, it adds to the general sharp downturn in asset values. Thus, this avenue of reliquification increasingly proves to be self-defeating for the corporate sector as a whole. Secondly, businesses slash employment in an attempt to preserve liquidity and slumping profitability. And thirdly, although for the time being the heat is on asset sales and employment, the third victim will be capital spending as recent intention surveys already indicate.

Earlier, we said that this economic downturn in the deficit-countries is consumer-led. Now we have to qualify that statement. It's falling consumer demand that leads the present recession, but in reality consumer income is a victim of the corporate profit and liquidity crisis.

WHEN OVERINDEBTEDNESS BEGINS TO PINCH

Much has been written about the debt stampede that has swept the Anglo-Saxon countries during the 1980s. Yet, the most crucial, deleterious aspect of these borrowing binges is hardly ever mentioned and apparently gets little recognition. That is the conjunction of mountains of nonproductive debt and compounding interest. In the case of governments and consumers, the unproductive aspect of their debts is self-evident. What's worse, however, is that even corporate borrowing in these countries was mainly for nonproductive purposes such as takeovers, leveraged buy-outs, and stock repurchases, all of which didn't add a mite to productive capacity.

Productive debt is both self-supporting and self-liquifying, but nonproductive debt inexorably turns into a debt-trap over time. Since it does not add to income growth, soaring debt-service costs eat up an increasing share of current income. A debt-fuelled consumption boom can therefore last only as long as the credit expansion progresses at an ever-accelerating pace and exceeds the ever-pressing advance of cumulating and compounding interest. There is simply no way of avoiding the final collapse of a debt-propelled consumption boom. By the way, that's exactly what happened in the United States during the 1930s and that's what is happening now in all the Anglo-Saxon countries.

To illustrate this debt-trap, a short look at the trend of U.S. consumer borrowing statistics is instructive. According to widespread perception, the American consumer is actively retrenching. That is wrong. During the third quarter of 1990, net new consumer borrowing amounted to $283.4 billion at an annual rate. That is virtually the same level of consumer borrowing that has prevailed ever since 1985, which was a time of extremely easy money. However, the same amount of borrowing which financed booming consumption in the past is now barely sufficient to cover soaring interest-service costs.

We hesitate to call this a "credit crunch". Obvious symptoms of overindebtedness are mistaken for signs of monetary tightness. The salient point here is that such economies overladen with nonproductive debt need more and more credit just to stay on the same spot. The crisis breaks when the financial system's power of credit creation can no longer keep up with the continually rising credit requirements of the economy.

Similarly, we see the same effect at work in fiscal policy. As an increasingly greater part of the budget deficit is absorbed by debt service, the deficits progressively lose their stimulative power. Presently, net interest costs paid by the U.S. government are running at a rate of $190 billion as compared to a budget deficit of approximately $200 billion not including S&L payments. The bailouts of the S&L's — needless to say — just like interest costs, have little or no stimulative impact on demand. For fiscal policy to act as a counter-recessionary stabilizer, ever larger budgets deficits are required as a percentage of GNP.

Overindebted consumers and corporations are not so much starving of credit as they are being strangled by illiquidity caused by the previous debt excesses. During the third quarter, U.S. GNP grew a nominal $77 billion while overall debt grew $177 billion, more than two times as much. This credit/GNP ratio is the sign of an economy that is illiquid and increasingly illiquifying, not reliquifying itself.

This brings us to the third culprit that we see unfolding in the Anglo-Saxon economic and financial saga: a "boom-bust" in asset price inflation.

ILLIQUIDITY HAMSTRUNG BY ASSET DEFLATION

Soaring asset values — mainly stock and house prices — were evidently a key propellant behind the past consumption boom in the deficit-countries we referred to earlier. It was a great dose of "asset price inflation" that provided a good deal of the collateral that backed the consumer's borrowing binge. As consumer borrowing and the asset boom interacted, savings collapsed. The ultimate result in these countries was the drastic shift in the demand and output structures towards overconsumption and underinvestment as already described.

It must have seemed like paradise on earth when rising asset prices and borrowing reinforced each other. The less the consumers saved, the more borrowed and spent, the richer they got through the roaring asset price inflation. Actually, the British were a lot better at this shell game than the Americans. Their debt leverage relative to current income rose from 62% to 112% between 1982 and 1989 as compared to a rise from 75% to 97% in the United States.

The new reality is that the magic perpetual-motion machinery of creating paper wealth by overspending has suddenly stalled. In fact, everywhere it has now kicked into reverse gear. Firstly, on the creditors side, asset deflation (primarily falling property prices) has put the brakes on the supply side of credit just at the moment when these economies need even more to survive. Secondly, for the illiquid debtor, falling collateral values now far outweigh the benefits of lower interest rates.

SUMMARY CONCLUSIONS

What is causing this recession in the Anglo-Saxon countries? What can be expected to jump-start the sagging economies again? These are the two key questions that must be answered as we try to assess the future course of financial markets and currencies.

First, to the all-important first question. For some time, it has been our aim to sharpen our insight into the deeper causes of these recessions. In this respect, we think, the present letter carries our analysis a large step further by focusing on the aspects of business profitability and liquidity.

The conclusion of our analysis is that all these economies are sliding into a vicious circle of a self-reinforcing profit and liquidity squeeze. Corporations and individuals can no longer generate cash, easy profits and income from continually rising asset prices. In the meantime, already declining incomes and profits are increasingly eaten up by interest payments. As assets fall in value and as more and more debtors are forced to sell assets, the prices of these fall even faster.

The key point to see is that the scramble for liquidity by selling assets and drastically cutting employment only spreads asset and income deflation. In the end, the very efforts of corporations and individuals to reliquify causes nothing but worsening illiquidity all-around. In essence, the fantasy movie of the 1980s runs in reverse, only at triple the speed.

Will easier money and lower interest rates be the panacea that saves these economies from the crushing jaws of overconsumption, underinvestment and debt deflation?

Wall Street likes to focus on the bright side of everything. But, to understand the present panicky euphoria in the stock and bond markets one has to be believe in a meek and mild recession coupled with dramatic declines in inflation and interest rates thus ushering in the economy's next automatic recovery.

Even the crushing debt burdens and the ailing banking system is now cast in a rosy light by way of the argument that they ensure a subdued recovery and therefore promise subdued inflation for an extended period. Apparently, happy days are here again.

While Wall Street fixates on lower inflation and easier money as sufficient preconditions for a recovery, in contrast, we focus first on business and consumer liquidity. Are they improving or deteriorating?

All this euphoric talk about lower inflation in America and the other Anglo-Saxon countries misses the crucial point of distinction: What is the underlying cause of lower inflation, falling costs or falling

profits? The answer is plainly obvious to anyone who cares to see. The fact is that there is an intensifying squeeze on already-low profits. Unfortunately, in the Anglo-Saxon countries, it is overwhelmingly the latter cause — namely, an intensifying profit squeeze. That, is not the recipe for recovery but rather for a deepening recession.

In addition, we pale at the sight of all the dismaying fundamentals that determine future growth and inflation: an exploding budget deficit already projected to exceed $300 billion, record-low personal savings of barely $160 billion, a profit crisis, a liquidity crisis, a productivity crisis, a real estate crisis, a banking crisis, and a dollar crisis.

Taking all this into consideration, we can only conclude one thing for America and the other Anglo-Saxon economies: there is no way out other than the disastrous road of massive credit expansion, inflation and permanent currency devaluation.

Publisher and Editor, *Currencies and Credit Markets*: Dr. Kurt Richebächer
Mendelssohn Strasse 51, D-6000 Frankfurt 1, GERMANY. TELEPHONE: 49-69-746908 FAX: 49-69-752583
Editors: Hahn Capital Partners Inc., International and Domestic Portfolio Managers
1175 North Service Rd, Oakville, Ontario, CANADA, L6W 2W1. TELEPHONE: 416-847-0010 FAX: 416-847-7742
Subscription and Administration Inquiries: Mulberry Press Inc. 7889 Sixteen Rd., Caistor Centre, Ontario, CANADA, L0R 1E0. TELEPHONE: 416-957-0602 FAX: 416-957-0602.

Annual Subscription Rates: 12 Issues. Europe: Sfr. 600.00. Subscribers outside of Europe: $US 400.00
Please inquire for multiple subscriptions. Languages: German/English. Please specify.